
Cyprus first implementation of the EU Anti-Tax Avoidance Directive

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The Cyprus Parliament voted on 5 April 2019 the first implementation law in Cyprus of the EU Anti-Tax Avoidance Directive (ATAD) and more specifically on the following areas:

1. Interest limitation rule
2. Controlled Foreign Company (CFC) rule
3. General Anti-Abuse rule (GAAR)

The first ATAD implementation law will enter into force on the date that it will be published in the Cyprus Government Gazette with an effective date as from 1 January 2019 i.e. for tax years 2019 and onwards.

The first ATAD implementation law impacts only Cyprus corporate income tax taxpayers (Cyprus CIT taxpayers) and more specifically:

- Cyprus tax resident companies, and
- Cyprus permanent establishments (PEs) of non-Cyprus tax resident companies

The remaining measures provided for in the ATAD are expected to be implemented in Cyprus in a second implementation law (anticipated to be passed in Cyprus later this year) which is expected to provide that such measures will be effective not earlier than the effective dates provided for in the ATAD, that is:

- Exit taxation provisions – 1 January 2020
- Hybrid mismatch rules – 1 January 2020 (exception: certain reverse hybrid mismatch provisions - 1 January 2022)

ATAD first implementation law in a nutshell

1. Interest limitation rule

1.1. Scope

Cyprus, consistent with the options foreseen by the ATAD, excluded from the scope of application of this rule:

- standalone companies i.e. companies that on a worldwide basis are not members of a group/have no associates/no PEs, and
- financial undertakings which broadly correspond to regulated financial undertakings such as banks, insurance entities, investment funds, pension funds and securitisation vehicles.

Where a Cyprus CIT taxpayer is a member of a Cyprus group the interest limitation rule applies at the level of the Cyprus group, otherwise it applies per company or per Cyprus PE. The Cyprus group for this rule has a 75% relationship condition and is referred to below as “the Cyprus group”.

1.2. How the rule works

The interest limitation rule limits the otherwise deductible exceeding borrowing costs (EBCs) of the Cyprus CIT taxpayer/Cyprus group up to 30% of adjusted taxable profit (taxable EBITDA).

The interest limitation rule contains an annual €3,000,000 safe-harbour threshold. This means that EBCs up to and including €3,000,000 is in any case not restricted by this rule (the €3,000,000 threshold would apply in cases where ‘30% of taxable EBITDA’ results to an amount below €3,000,000). In the case of a Cyprus group the €3,000,000 applies for the aggregate EBCs of the Cyprus group and not per taxpayer.

The taxable EBITDA is computed by adding back to the taxable profit of the year the EBCs, depreciation, amortisation and deductions in relation to tangible/intangible fixed assets. The 80% Cyprus ‘IP Box’ deduction on qualifying IP profits is added back to the taxable profit for the purposes of determining the taxable EBITDA.

EBCs are defined as the amount of tax deductible borrowing costs in excess of the amount of taxable interest income/other taxable income economically equivalent to interest.

The term ‘borrowing costs’ is broadly defined and covers interest expenses on all forms of debt, other costs economically equivalent to interest expenses as well as expenses incurred in connection with the raising of finance including, for example, payments under profit participating loans, financing related hedging costs and guarantee fees. Consistent with the OECD BEPS Action 4, from which the interest limitation rule derives, the annual Cyprus Notional Interest Deduction (NID) which is calculated on new equity (introduced in Cyprus with effect from 1 January 2015) is not considered as ‘borrowing costs’ for the purposes of this rule.

The interest limitation rule applies to EBCs irrespective of whether the financing is with related parties or third parties.

1.3. Specific exclusions

Grandfathering of loans concluded before 17 June 2016

When determining the amount of deductible EBCs that may be limited under this rule, the EBCs of loans concluded before 17 June 2016 are excluded and remain deductible. This exclusion shall not extend to any subsequent modification of such loans.

Long-term infrastructure projects

When determining the amount of deductible EBCs that may be limited under this rule, the EBCs, arising from loans used to finance long-term infrastructure projects in those cases where the project operator, borrowing costs, assets and income are all in the EU are excluded and remain deductible. The corresponding taxable profit from such long-term infrastructure projects is excluded from the taxable EBITDA.

Group equity escape

There is an annual election for a group equity escape, which is based on the level of equity of the Cyprus CIT taxpayer/Cyprus group as compared to the level of equity within the Cyprus CIT taxpayer’s/Cyprus group’s consolidated group for financial reporting purposes (on a world-wide basis). In cases where the ratio of “equity/total assets” is higher at the level of the Cyprus CIT taxpayer/Cyprus group (or even up to 2% lower) as compared to its consolidated group for financial reporting purposes (on a world-wide basis), the interest limitation rule, in effect, does not apply for that tax year.

1.4. Carry forward

The interest limitation rule also contains carry forward provisions. EBCs not deductible in a tax year due to the application of this rule may be carried forward to future tax years for up to 5 years. This 5-year carry forward is in line with Cyprus' 5-year income tax loss carry forward rule.

Additionally unused interest capacity (i.e where the amount of 30% of taxable EBITDA is in excess of the EBCs for a tax year) that has not been utilised within a tax year may be carried forward for use for the next 5 tax years.

The above carry forward provisions are subject to an anti-abuse rule in certain cases of change in ownership of the company.

2. Controlled Foreign Company (CFC) rule

2.1. Scope

A CFC is a low taxed non-Cyprus tax resident company in which the Cyprus CIT taxpayer, alone or together with its associated enterprises, holds a direct or indirect interest of more than 50%.

A CFC is also a low-taxed foreign PE of a Cyprus tax resident company that is exempt from tax in Cyprus (exempt foreign PE)

A non-Cyprus tax resident company (or an exempt foreign PE) is considered as low-taxed if the actual foreign corporate tax paid by it on its profits is lower than 50% of the corporate income tax charge that would have been payable in Cyprus under the Cyprus corporate income tax rules had it been a Cyprus tax resident company.

2.2. Exceptions

The CFC rule does not apply to non-Cyprus tax resident companies (or exempt foreign PEs):

- i) with accounting profits of no more than €750.000 and non-trading income of no more than €75.000; or
- ii) of which the accounting profits amount to no more than 10% of their operating costs for the tax period. For the purposes of this exception operating costs do not include the cost of goods sold outside the country where the non-Cyprus tax resident company (or the exempt foreign PE) is tax resident and payments to associated enterprises.

2.3. Targeted income

Cyprus has opted for the Model B approach as foreseen in ATAD.

When a non-Cyprus tax resident company (or an exempt foreign PE) meets the definition criteria of CFC (refer to Scope, section 2.1 above), the Cyprus CIT taxpayer must include in its taxable profit the non-distributed income of the CFC to the extent such income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage (refer to Non-genuine arrangement test, section 2.4 below).

Non-distributed income of the CFC is defined as the after tax accounting profit of the CFC, which has not been distributed to the Cyprus CIT taxpayer during the Cyprus tax year in which the CFC profits are included (refer to Inclusion rules, section 2.5 below), or within the next seven months.

2.4. Non-genuine arrangement test

An arrangement or series thereof shall be regarded as non-genuine to the extent that the CFC would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by the Cyprus CIT taxpayer where the significant people functions (SPFs) which are relevant to those assets and risks, are carried out and are instrumental in generating the CFC's income.

2.5. Inclusion rules

The non-distributed income of the CFC included in the taxable profit of the Cyprus CIT taxpayer shall be limited to amounts generated through assets and risks which are linked to the SPFs in the Cyprus CIT taxpayer and is calculated based on arm's length principles. Further, this amount shall not exceed the amount of the non-distributed income of the CFC (grossed-up for the CFC's foreign corporate tax paid) which resulted from assets and risks associated with the SPFs carried out by the Cyprus CIT taxpayer.

The same provisions apply in those cases where the CFC generates losses instead of profits.

The CFC income or loss, depending on the case, to be included in the taxable profit of the Cyprus CIT taxpayer is calculated based on the Cyprus CIT taxpayers' percentage of entitlement of the CFC's profits. The CFC income or loss must be included in the Cyprus tax period in which the tax year of the CFC ends. Upon inclusion, such income or loss shall be subject to the normal Cyprus corporate income tax rules.

2.6. Avoidance of double taxation on CFC income

Cyprus shall grant a tax credit against the Cyprus corporate income tax payable for certain taxes paid abroad on the CFC income.

Additionally rules have been put in place to prevent double taxation in Cyprus in cases where income that has previously been included in Cyprus under the CFC rule is subsequently actually distributed or realised through a disposal of investment.

3. General Anti-Abuse Rule

The Cyprus ATAD first implementation law includes the ATAD GAAR. This requires (for the purposes of calculating the Cyprus corporate income tax liability of the Cyprus CIT taxpayer) an arrangement or a series of arrangements to be ignored where these, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances.

An arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

Takeaway

The Cyprus ATAD first implementation law is further clear indication of Cyprus's willingness to comply fully with EU tax initiatives and to adapt fully to a "post-BEPS" international tax environment.

Clarifying interpretative circulars are expected to be issued by the Cyprus Tax Authority (CTA) in the coming months in order to provide more practical guidance on this law.

Let's talk

For a deeper discussion of how this development might affect you or your business, please contact:

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